Control and Boundaries of the Firm in the International Franchising : A Case Study of Coca-Cola Company in Japan

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Control and Boundaries of the Firm in the International Franchising: A Case Study of Coca-Cola Company in Japan*

Takatoshi Murayama**

Abstract. This article attempts to expand the boundaries of multinational corporations from an equity mode (foreign direct investment) to a non-equity mode (franchising). Franchising by Coca-Cola Company in Japan is investigated to reveal the mechanism of international internal control between franchisors and franchisees. The existence of an effective control mechanism is confirmed, while the narrow and restrictive scope of conventional theory is critiqued. Finally, the necessity to consider flexible boundaries of multinational corporations is suggested to understand the real significance of multinational corporations.

Key Words. International franchising, multinational corporations, non-equity modes, power and control, flexible boundaries of multinational corporations

Introduction

Currently, global service companies, some of which use franchising to expand their business in foreign markets, are rapidly growing. Those companies enlarge not only their corporate brands but also power of control in the global economy. Nevertheless, it can be thought that research on international franchise companies has been fruitless so far. Especially, analyzing internal mechanisms of international franchise companies is now being urged (Paswan, 2002).

The purpose of this article is to investigate the inside of a worldwide franchise company: whether franchisors can control their foreign franchisees and also how franchisors can control the operation of franchisees. If the companies can effectively control them, this research also implies to extend the boundaries (Coase, 1937; Felstead, 1993; Williamson,

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** Takatoshi, Murayama is Associate Professor of International Business Marketing and Management, Department of Business Administration, Faculty of Economics, Tohoku Gakuin University, 1-3-1 Tsuchitoi, Aobaku, Sendai, Miyagi, Japan, ZIP 980-8511 E-mail; takatoshi@tscc.tohoku-gakuin.ac.jp

1975) of multinational corporations (*hereinafter* MNCs). In order to deal with these questions, the internal operations of Coca-Cola Company[1] in Japan are examined.

Analytical Framework : A Definition of MNCs

The definition of an MNC has been closely linked with foreign direct investment (FDI) since Hymer's dissertation, a breakthrough, in 1960. Hymer (1960) had emphasized "control" of foreign business units (*e.g.*, foreign subsidiary, foreign branch, foreign sales office and so forth) by its headquarters, and then recognized FDI as a strong tool of control. Many international business scholars, such as Buckley and Casson (1976), Dunning (1988) and Kindleberger (1969), have followed and sophisticated Hymer's conventional definition of the MNC.

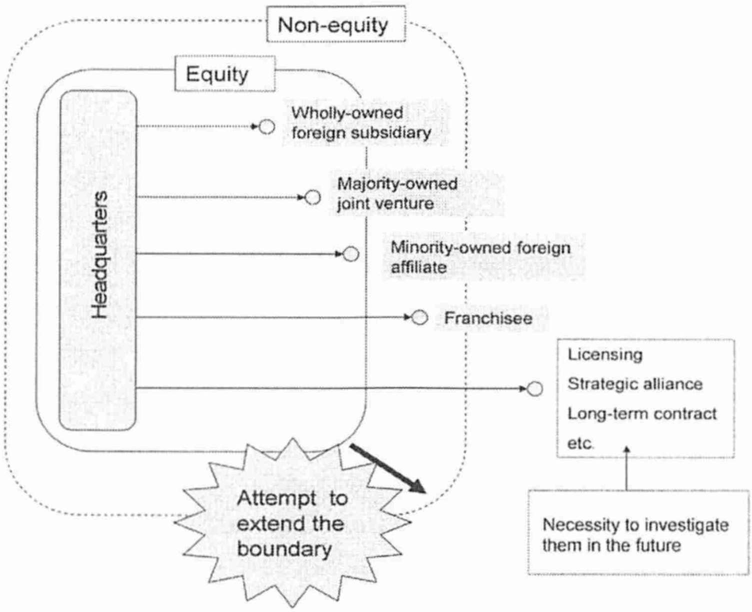
A definition that emphasizes the control aspect of an MNC might be still valid. A problem, however, is modes of control. Most of the conventional theories, if not all, stated that the ownership of the equity stake of foreign business units, known as an equity mode, constitutes control of that unit. For instance, Jones (1996, p. 5) stated that "the basic idea that MNEs (multinational enterprises) engage in FDI which enables them to own and control assets in foreign countries is straightforward. FDI is conventionally used as a proxy to measure the extent and direction of MNE activity."

However, especially in recent years, it has been becoming common for companies to exploit non-equity modes, such as strategic alliances, licensing, franchising, leasing, management service contracts and long-term contracts, to expand their business activities and assets across borders (Contractor and Kundu, 1998 ; Erramilli *et al*, 2002 ; Quinn and Doherty, 2000). If the boundary of an MNC is simply defined by the "flow of FDI," the international companies that utilize non-equity modes aren't categorized as MNCs.

In contrast, if the boundary is defined in "term of control," the outcome will be slightly different from that suggested by the conventional theory. In other words, the possibility that companies can tightly control their foreign businesses and assets by the use of non-equity modes exists there, and also the companies might be recognized as the MNCs (*see* figure 1). At any rate, it is necessary to revisit the question raised by Caves (1996, p. 1) in the past ; that is, "What constitutes 'control' over a foreign establishment is another judgmental issue." International business scholars should positively deal with this "judgmental" issue and have to judge the real significance of MNCs in the present global society.

This article focuses on international franchising as a typical non-equity mode, which is not based on ownership, but on formal agreement between franchisors and franchisees, which

Figure 1. Modal Choices and Boundaries of MNCs



are independent businesses. Especially, the mechanism to control the foreign franchisees is investigated here. Also, if control through franchising is confirmed, it follows that the definition of MNC ought to be expanded to include non-equity modes as well as equity modes. In the next section, the internal and international business process of Coca-Cola Company in Japan is examined to clarify the relation of franchising to controlling.

Strategy and Control in Coca-Cola's Franchise System

"Bottling System" Based on the Franchise Agreement

It is well-known that Coca-Cola Company mainly uses franchising, known in Japan as the "bottling system," to expand their business operations domestically and internationally. Their so-called "business format," consisting of their production system, expertise in marketing and distribution, trademark, and concentrate of their drinks, is transferred to local franchisees through the franchise agreement.

Coca-Cola Company had made its first franchise agreement with two local businessmen of Tennessee on July 21, 1899 (Coca-Cola Japan Company, 1987; Pendergrast, 1993). This first 600-word contract clearly became a prototype of the current more sophisticated agreement.[2] In the agreements, local franchisees, often known as "local bottlers," are granted the exclusive right to a territory, and also they have to build their production sites, hire employees, procure delivery vehicles and other materials, and develop local distribution channels using their own investments in the territory (*see* figure 2). In contrast, Coca-Cola Company is obligated to transfer its business format and sales promotion programs to support the business development of the local bottlers. The local bottlers also have to purchase concentrate of the drinks from Coca-Cola Company and, needless to say, it becomes the main revenue of Coca-Cola Company (Kohno and Murayama, 1997).

The wholesale price of the concentrate includes not only the cost of the concentrate itself, but also royalties for using the Coca-Cola Company's expertise and trademark. Most of Coca-Cola Company's revenues are generated from selling the concentrate to the local bottlers. Thus, if the sales volume (not profit) of the local bottlers expands, the revenue of Coca-Cola Company also increases. In other words, the financial result of Coca-Cola Company is heavily dependent on the sales performance of the local bottlers, such that Coca-Cola Company has strong incentive to expand the sales volume of the local bottlers. Franchising is also recognized as the "reciprocal business system"; franchisers can quickly expand their revenue without their own investment for physical equipment and, in contrast, franchisees can smoothly launch their business relying on the transferred business format.

A "Japanese Coca-Cola bottling system" had been structured by 17 bottlers and a foreign subsidiary of Coca-Cola Company until 1999 (*see* figure 3). In recent years, however, some

Figure 2. Franchise System of Coca-Cola Company

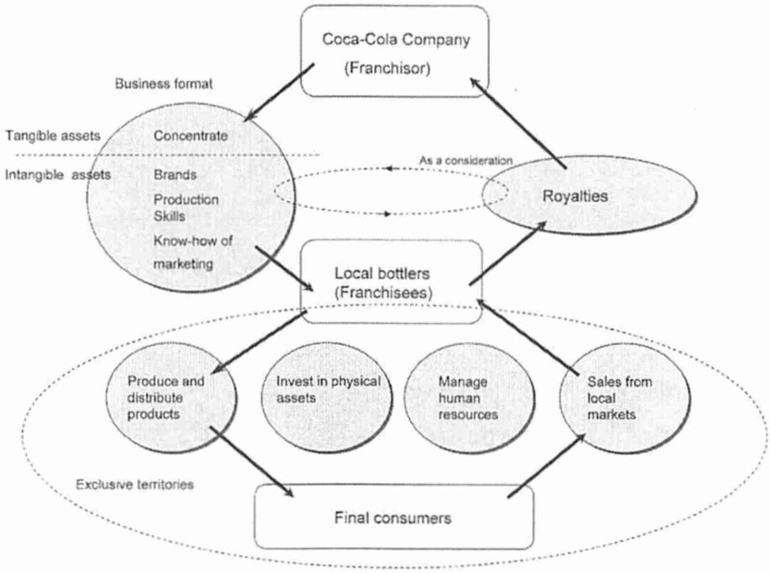
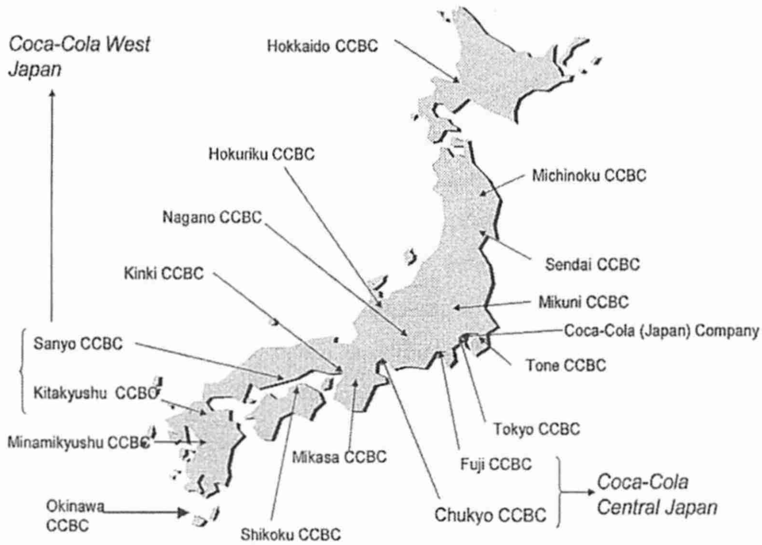


Figure 3. Geographical Location of Japanese Bottlers



bottlers, such as Coca-Cola West Japan and Coca-Cola Central Japan, merged with other bottlers to form "anchor bottlers" in order to share strategic objectives with Coca-Cola Company, to pursue greater economies of scale and scope (Felstead, 1993), and to sustain competitive advantages against a new strong competitor, Pepsi-Suntory (a Japanese large alcoholic and beverage producer) coalition formed in 1997.

The duration of a franchise agreement is basically 10 years in Japan. In many cases, it might be expanded to 20 years without renegotiating process. If there are not any serious violations of the agreement in the previous contractual term, the same bottler could legally renew the agreement regarding the same territory (Emerson, 1998).

International Strategy

Coca-Cola Company operates its business system in nearly 200 countries (The Coca-Cola Company, 2001) and has an international strategy to integrate its worldwide operations. The fundamentals of the international strategy, consisting of "product standardization" and "localization," had been formulated by Robert W. Woodruff (known as "The Boss") in the 1930's and have guided its internationalization process ever since.

The strategy of product standardization exists to maintain the same high quality and the same flavor of products, "Coca-Cola," "Sprite," "Fanta," "Mello Yellow," "Minute Maid" and so forth, all over the world, thus creating a globally unified brand image of Coca-Cola

Company and its products in the huge global market. The corporate brand and product brands are the most valuable intangible assets, which value is equivalent to $70.45 billion in 2003 (Reuters News Service, 2003), to generate revenues in Coca-Cola Company. Hence, Coca-Cola Company places the highest priority on protecting their value.

Localization has been based on one of Woodruff's credos (Coca-Cola Japan Company, 1987) ; "A healthy world economy depends on a healthy local economy." Thus, Coca-Cola Company organizes business partnerships with local franchisees and the franchisees procure ingredients, containers (bottles and cans), production equipment, delivery vehicles and so on from local markets in order to promote healthy local economies. If the wage levels and the living standards rise because the local economy is developing, people can afford to purchase soft drinks including Coca-Cola Company's brands. Moreover, Coca-Cola Company can expect to avoid hostility from local consumers by promoting friendships with local economy and industry.

Control of Bottlers' Operations

Coca-Cola Company has to control the local bottlers, which produce and distribute products in each local market, to operationalize the international strategy well. In this section, several control mechanisms of franchising, such as monitoring system, information system and sharing of benefits, in Japanese market are investigated.

Monitoring System. It is dispensable for product standardization, an essential part of the international strategy, that the local bottlers purchase the right concentrate from Coca-Cola Company, use the right materials approved by Coca-Cola Company, and manufacture and distribute products using the right method. Thus, Coca-Cola Company has a monitoring system to ensure that the local bottlers never deviate from the proper procedure. In the Japanese market, Coca-Cola Japan Company Ltd. (*hereinafter* Coca-Cola Japan), a wholly-owned foreign subsidiary of Coca-Cola Company, implements periodic secret inspections of final products in each local bottler's market. After picking up samples from vending machines, shelves of retail store and so forth in each bottler's territory, and bringing them to Coca-Cola Japan's chemical laboratory, Coca-Cola Japan analyzes their ingredients and formulas. If a local bottler violates the technical conditions specified by Coca-Cola Company, Coca-Cola Japan enforces the bottler to review its manufacturing process and advises it on corrections. Of course, Coca-Cola Company can terminate the franchise agreement in the worst cases. Also, Coca-Cola Japan keeps the inspections secret, especially about when and where, so that each bottler has to be sensitive to their quality control at all times.

Even if the strategy of localization described in textbooks of international management involves decentralization of power to local franchisees (Bartlett and Ghoshal, 1989 ; Porter, 1986), it is operationalized with centralized control policy in Coca-Cola Company. For instance, regarding local procurement of product materials, the local bottlers are never permitted their own discretion in choosing suppliers. Coca-Cola Company and Coca-Cola Japan hold the power to select suppliers, to examine the quality of materials produced by the suppliers and to approve them. In the case of building a new plant, for instance, even if the local bottlers are obligated to finance all of it, they also have to accept detailed technical inspections, implemented by Coca-Cola Japan's technical staff, regarding building sites, quality of water, plant layout and so on. In other words, Coca-Cola Company can fully interfere in the production process and quality control system of the new plant owned by the local bottlers without any financial obligations.

Information System. An information system is also indispensable to an effective controlling system. Coca-Cola Company and Coca-Cola Japan have to analyze constantly incoming information regarding local bottlers' behaviors.

"Area Marketing Managers" (*hereinafter* AMMs) have an important role in gathering information of local bottlers and linking Coca-Cola Company's strategy to local bottlers' operations. The AMMs, employed by Coca-Cola Japan, visit the local bottlers' offices several times for a week. In this process, they send the local bottlers documentation regarding Coca-Cola Company's business plans, product policies, marketing and sales promotions, while simultaneously gathering the information regarding business plans, performances and managerial problems of the local bottlers.

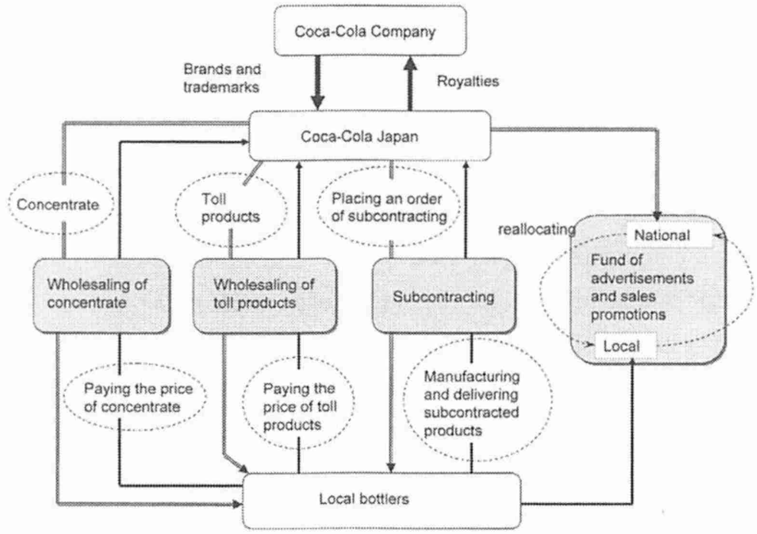
The information gathered by the AMMs is constantly brought back to Coca-Cola Japan, and shared and analyzed among the departments of Coca-Cola Japan, such as the technical department (including quality control and production), the marketing department and the "support staff" (regarding legal and public relation)[3], and then sent to Coca-Cola Company's world headquarters by the use of the internal "global information system." For example, industrial analysts commented on the information system structured by Roberto Goizueta and Douglas Ivester, who are the former CEOs of Coca-Cola Company, as follow ; "the company's global system, which gathers bottler data from all over the world and is accessible through the company's information network. The company carefully monitors what is happening market by market worldwide. Any trends that develop are picked up and projects are monitored monthly. 'Having that information system, and seeing from sales data that things aren't going the way they should [in a particular market] — within a week,' makes it much easier for the company to jump on a given problem or opportunity" (Holleran, 1996, p. 35). Obviously, Coca-Cola Company not only utilizes the information for controlling bottlers' operations but also uses it in the formation of new business policies.

Economic Flows and Sharing of Benefits. At least four economic flows between Coca-Cola Company and the local bottlers can be confirmed (*see* figure 4).[4]

Regarding the wholesale purchase of concentrate, as referred to above, the bottlers are obligated to purchase concentrate from Coca-Cola Company at a certain price. Thus, since the dilution rate of concentrate is fixed, the revenue of Coca-Cola Company rises in proportion to expansion of the bottlers' sale volume. The price of concentrate is legally determined by Coca-Cola Company, while it does change due to inflation, currency fluctuation and other reasonable reasons. Although changing the price is a subject of negotiation between Coca-Cola Company and the local bottlers, Coca-Cola Company might hold the stronger negotiating position against the local bottlers because of its monopoly power as the only seller of concentrate. A certain portion of the concentrate price, as a consideration for using valuable brand name and trademark, is transmitted to Coca-Cola's world headquarters through Coca-Cola Japan.

Regarding the toll product (*see* also Felstead, 1993), the local bottlers are forced to purchase several finished products called as the toll products, such as "*So-Ken-Bi-Cha*" (a Japanese mixed ready-to-drink tea), "Minute Maid" and so forth, from Coca-Cola Japan.

Figure 4. Economic Flows in Coca-Cola Business



In this case, the local bottlers pay Coca-Cola Japan for the wholesale price of the toll products, and then add the margin and sell them to retailers or final consumers. The pricing process of the product might be similar to that of the concentrate.

Regarding the subcontracted products, more complicated than the other deals, Coca-Cola Japan subcontracts the bottlers, especially who own well-developed facilities, to manufacture certain products, such as "*So-Ken-Bi-Cha.*" Subsequently, Coca-Cola Japan once purchases the products from the bottlers by paying the manufacturing cost, and then wholesales them, as the toll products, to the bottlers again. Also, Coca-Cola Japan and the bottlers sometimes jointly invested in the new production facilities for the subcontracted products. Needless to say, the differential between the manufacturing cost paid to the bottlers and the wholesale price of the toll products paid by the bottlers becomes gross profits of the subcontracted products for Coca-Cola Company and Coca-Cola Japan.

Regarding the sharing of expenditures for marketing and sales promotions, while Coca-Cola Company and Coca-Cola Japan are logically obligated to fund the nationwide advertisements and sales promotions for enhancing the value of the Coca-Cola's brands themselves, the local bottlers basically supply the funds for regional-based advertisements and sales promotions. The regional marketing and sales promotion expenditures funded by the bottlers are included in the price of the concentrate, and thus, as the bottlers purchase the concentrate, the expenditures are once collected by Coca-Cola Japan. Subsequently, the local bottlers are required to formulate annual local marketing and sales promotion plans for their territories and to budget for those plans. Eventually, Coca-Cola Company and Coca-Cola Japan reallocate funds to each bottler's plan through cost and benefit analysis although some discretion in these decisions might be involved. This means that, even if the expenditure is shared by Coca-Cola Company and the local bottlers, Coca-Cola Company might have the greater influence on how to use it.

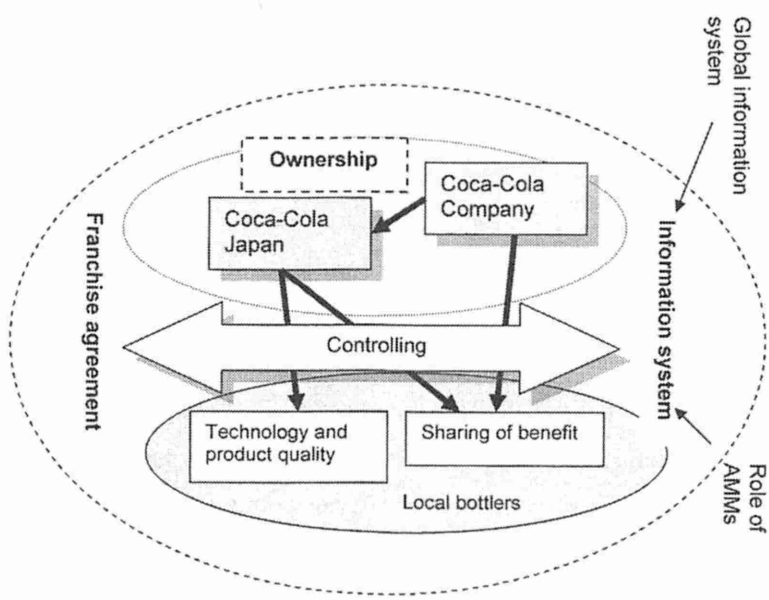
Discussion and Implications

Mechanism of Control. Felstead (1993, p. 203), by investigating Coca-Cola's franchise business in Germany, remarked that "in the case of franchising, economic power is exercised not by directly owing and controlling the physical assets of doing business, but by controlling the use to which the intangible assets, such as the trade mark/idea/format, are put." In addition, this paper attempted to clarify the detail of Coca-Cola's internal control mechanism. As summarized in figure 5, Coca-Cola Company directs Coca-Cola Japan to monitor tightly the behaviors of the local bottlers. Coca-Cola Japan might take responsibilities for controlling the aspects of technology and product quality, and sharing of benefits while Coca-Cola Company might be obligated to influence the process of sharing benefits just by changing the wholesale price of concentrate.

In the international franchise, since the headquarters is limited to approach local franchisees because of physical and psychological distance, the majority-owned foreign subsidiary, such as Coca-Cola Japan, should play vital roles to control the foreign local franchisees through closely monitoring instead. Although the control mechanism, named here as "indirect (=non-equity) control combined with direct (=equity) control," differs from that based on FDI, it is still confirmed that the franchisor (Coca-Cola Company) can effectively control the foreign franchisees (foreign local bottlers) there.

Moreover, it should be emphasized that the well-established information system might constitute the essentials to make the control mechanism effective. In the case of Coca-Cola business in Japan, the AMMs hired by Coca-Cola Japan convey the information regarding the Coca-Cola's business policies and the local bottlers' operations from Coca-Cola Company to the bottlers and *vice versa*. Such human networking based on the AMMs' activites, compared to the computer-based networking, holds an advantage to gain verbal and non-verbal information deeply embedded in the decentralized local business context in which the local bottlers operate. Clearly, those kinds of local information system are indispensable to link the Coca-Cola's strategy to the local bottlers' implementation, especially in the high-context

Figure 5. Mechanism of Control of Coca-Cola Company in Japan



society, such as Japan (Hall and Hall, 1987; Ogawa, 1999).

As the practical and managerial implications for successfully controlling of the international franchise chain, this article might underline that franchisors should organize the well-operated and majority-owned foreign subsidiaries, as local franchisors, and then establish the human-based networking, led by the local franchisors, to gain the local information.

Defining the Boundaries of MNC. As mentioned above, franchising might allow Coca-Cola Company to control the local bottlers effectively. In particular, monitoring (sampling inspection and approved local procurement) and the information system (work of AMMs) through Coca-Cola Japan become key tools of control. In addition, Coca-Cola Company has an influence on how benefits are shared with the local bottlers. Such indirect, but tight, control through franchising raises a theoretical question: whether this entity that controls foreign business operations through a non-equity mode would be recognized as an MNC.

Under the conventional theory, such as advocated by Hymer (1960), this entity would never be recognized as an MNC. The conventional theory would lead to the interpretation that Coca-Cola Japan, as a wholly-owned subsidiary, is included in the boundaries of the MNC, but the local bottlers (franchisees) are excluded because of the lack of ownership (FDI) linkage. Meanwhile, if the element of control is emphasized, one is led to different conclusion. In fact, an effective management cycle of planning, doing and monitoring (*see* figure 6) has been established between Coca-Cola Company and the local bottlers. If one accepts the premise that the notion of control is the key in defining what constitutes an

Figure 6. Management Cycle and Control in Coca-Cola Company in Japan

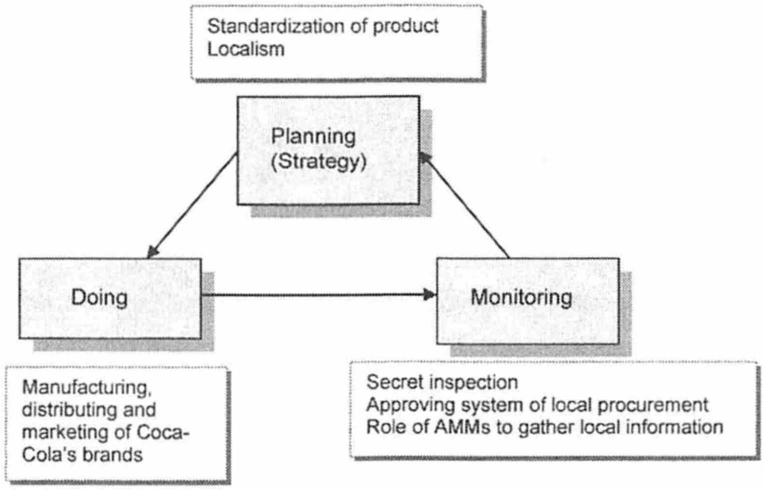


Figure. 7. Boundaries of MNCs Based on Two Different Perspectives

	HQs	Coca-Cola Japan (100% owned)	Local Bottlers (Franchisees)
Conventional Perspective "Ownership"	Internal	Internal	External
New Perspective "Control"	Internal	Internal	Internal

internal organization, it follow that even the Japanese bottlers, as franchisees, are within the boundaries of the MNC known as Coca-Cola Company (*see* figure 7). Eventually, it is implied that the concept of control, especially in the international business study, have to detach from the flow of FDI, and then it bring international business scholars more comprehensive interpretation regarding the nature of power and control of MNCs.

Conclusion

Global service industries, some of them utilizing franchise system to expand their businesses, are rapidly growing with power and control in recent years. Not surprisingly, this movement will gradually lead to modification of the conventional definition of MNCs.

For instance, Jones (1996, p. 6) has already pointed out that "the existence of intermediate modes between exporting and wholly-owned FDI re-inforces the critical point that the real significance of MNEs is not as an institutional vehicle for foreign investment." Also, Buckley and Casson (1998) have emphasized that new models of the MNC should take account of the "flexible boundaries of the firm" and their competitive advantages. Some other researchers have already begun the empirical studies to investigate effectiveness and advantages of non-equity modes, such as franchising, management contracts and licensing, as foreign entry strategies and international distribution channels (Contractor and Kundo, 1998 ; Erramilli *et al*, 2002), and the dynamic nature of power and control in the international franchise business (Quinn and Doherty, 2000).

This article suggests expanding the organizational boundaries of MNCs to include non-equity relationships as well as equity relationships is becoming essential to understand the real significance of MNCs. For instance, the conservativeness of Japanese market for foreign MNCs is sometime critiqued by foreign governments mainly based on the statistics of FDI. However, if the argument had taken account of the penetration of foreign franchise business owned by Japanese franchisees, such as in fast food and cafe businesses, in Japan (Hibbert, 2003), it might lead to the opposite conclusion; that is, the openness of Japanese market.

Notes

1 However, the official company name imprinted in the annual report is "The Coca-Cola Company", not "Coca-Cola Company."

2 Obviously, Coca-Cola Company does not disclose the full text of franchise agreement for outsiders. A few scraps of the agreement, however, were referred in the interviews with several Japanese local bottlers. The interviews were conducted as follows: Chukyo Coca-Cola Bottling (March 26, 1996), Coca-Cola Japan Company (March 27, 1997), Coca-Cola National Sales Company (March 26, 1997; July 22, 1999), Hokuriku Coca-Cola Bottling (June 4, 1999), Kinki Coca-Cola Bottling (September 8, 1999), Kitakyushu Coca-Cola Bottling (March 28-29, 1999) and Sendai Coca-Cola Bottling (May 2, 1996).

3 Coca-Cola Japan has never disclosed outsiders its organizational chart. The organizational structure of Coca-Cola Japan described here is based on interviews with Coca-Cola National Sales Company (CCNSC) that is a sales agent founded in 1995 to sell Coca-Cola's products to several big nationwide retail chain stores.

4 Based on annual financial statements of some listed local bottlers, Chukyo Coca-Cola Bottling, Fuji Coca-Cola Bottling, Hokkaido Coca-Cola Bottling, Kinki Coca-Cola Bottling, Kitakyushu Coca-Cola Bottling, Mikasa Coca-Cola Bottling, Mikuni Coca-Cola Bottling, Sanyo Coca-Cola Bottling, are referenced.

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